

SOME MEXICAN PROBLEMS OF INTERNATIONAL
ECONOMIC ADJUSTMENT, 1925 TO THE PRESENT

BY

NATHANIEL JACKENDOFF

B.S., City College of New York, 1938

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AN ABSTRACT OF A THESIS

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN ECONOMICS
IN THE GRADUATE COLLEGE OF THE
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Despite the existence of a long-standing interest in Pan American relations in the United States relatively little has been written, of more than a superficial nature, on the economies of the Latin American nations, except for some studies of Argentina, Brazil and Chile. The paucity of material in both English and Spanish has suggested the need for a somewhat historical study of the relationships between the Mexican economy and the outside world in order to provide a perspective for more detailed studies. Furthermore, because of the unavailability of background material on the banking and monetary systems, which are the most important channels through which changes in the balance of payments are transmitted to the domestic economy, the writer has gone into the development of these institutions in some detail.

The period chosen for study was 1925 to the present, partly because for practical purposes of research this was most feasible, but more especially because these are the years in which the most important changes have occurred in the Mexican economy with which one must be familiar in order to understand current developments. The organization of the paper has been chronological, following the movements of the business cycle and the developments of the last war. Besides giving a running account of general developments in the international balance of payments, and the repercussions on and developments in the monetary and banking systems, this approach has also been advantageous for the purpose of highlighting particular problems which existed during the periods chosen.

Mexico left the silver standard in 1905, setting up a gold-exchange standard in order to adapt her currency system to that of the major trading nations of the western world. The authority to regulate the currency was in the hands of a special Commission of Money and Exchange, although note issuance was authorized to a number of private banks. The revolutionary period, 1910 to 1917 approximately, brought a

deluge of paper money, a situation which was not remedied until 1917. A wartime rise in the price of silver placed the white metal at a premium, and left the country with a monetary stock almost completely composed of gold coins. A decree of November 13, 1918 placed Mexico on a nominal gold standard.

After February, 1920, the price of silver began to fall on the world market and soon this decline reversed the relationship between silver and gold, placing the latter at a premium. The decline of silver was particularly abrupt in 1926, followed by partial recovery until 1929. Efforts by the Regulator Fund of the Bank of Mexico to prevent further discount of silver coins were halted in October, 1926 as the gold stock of the country became precariously small. The discount reached an average monthly peak in February, 1927 of almost twelve percent, after which it declined to less than four percent in 1928. It has been suggested that the decline in the value of the silver peso was related primarily to the coinage policy of the government, but the facts do not entirely bear this out. The decline may be most fundamentally related to the weakness of the gold reserves of Mexico and the government's inability to maintain redeemability of silver coins at a time when the commercial value of the former was declining most rapidly. Nevertheless, a prohibition on further coinage of silver, as of February 25, 1927, may have helped to increase confidence in the currency and to stem the decline in the silver discount.

Organized commercial banking in Mexico is of comparatively recent origin, having grown up during the period of so-called capitalistic development under the Diaz regime. The revolutionary period resulted in an almost complete breakdown of the banking and monetary systems, the banks of issue being liquidated in 1916 following the cancellation of their note issue privilege. The better situated ones were returned to legal existence in 1921, but without retaining the note issue privilege. A general reorganization of the banking system occurred in 1925. A General Law of Credit Institutions became

effective in January, 1925, defining the functions of various types of banks and setting reserve requirements on sight deposits at a minimum of thirty-three percent. A National Banking Commission began operation in February, 1925, primarily for the purpose of supervising the banking system to see that the provisions of the banking laws were carried out. In 1928 it was given authority to vary reserve ratios on sight deposits between twenty and thirty-three percent. It set them at thirty percent.

In August, 1925 the Bank of Mexico was established with the functions of issuing banknotes, regulating coinage, currency, and foreign exchange, rediscounting for the associated institutions, acting as financial agent for the federal treasury, and engaging in general operations of discount and deposit with the public. Specific limitations were imposed on its power to lend to the government. Association with the Bank of Mexico by private credit institutions was voluntary. A fifty percent gold reserve had to be maintained behind Bank of Mexico notes.

Banking activity during the period 1925 to 1929 was limited because of political instability. The banks maintained highly liquid positions, and kept large proportions of their reserves abroad. The rise of lending during the period was largely due to the activities of the Bank of Mexico, whose loans were mostly confined to the public as the few associated banks seldom availed themselves of the rediscount privilege. The direct competition between the Bank of Mexico and the commercial banks has been blamed for the restricted lending policies of the latter, but it is probable that there was need for more widespread banking facilities than the commercial banks made available to the public. It is generally admitted that the Bank of Mexico engaged in excessive lending to the government, leaving the bank with a large frozen portfolio for almost ten years after the reform of 1932.

The study of Mexico's problems of international economic adjustment is most significantly related to the limited sector

of the Mexican economy properly called the monetary economy, a large portion of the population living in a subsistence or barter economy remote from the cities, the railroads and the ports. The country's merchandise exports have been mostly raw materials, primarily minerals, while the imports have included a diversity of manufactured goods. Over half of Mexico's foreign trade is normally with the United States, Europe dominating the remainder of the trade.

After 1926, total exports declined continuously into the depression, petroleum being the principal variable. By excluding petroleum, however, we find that exports increased, the major factor here being the growth of industrial metal exports in response to rising industrial production in the important manufacturing countries. Imports declined from 1925 to 1927, but rose from 1927 to 1929. The balance of payments was evidently in serious disequilibrium even before the depression, though there was some tendency toward improvement in 1929. The greatest trouble existed between 1926 and 1928 as was indicated by the co-existence of a merchandise export balance, and an outward flow of monetary gold coinciding with a fluctuating decline in the value of the gold peso. This was probably due to outward movements of capital prompted at least partially by domestic political instability. Payments on the external public debt in 1926 and 1927 were probably also partially responsible for the pressure in those years. Payments were suspended, however, in 1928.

The world depression following the stock market crash in the United States in October, 1929, had serious repercussions upon the Mexican economy, which was just beginning to recover from a period of prolonged political and economic instability. The impact was most sharply felt in a very steep decline in exports and imports, and in losses of monetary reserves. The result was an acute monetary and banking crisis which came to a head in July, 1931 after futile attempts to maintain the values of the gold and silver pesos.

The Monetary Reform of July 25, 1931 demonetized the

gold peso, although maintaining a legal parity between gold and silver. The exchange rate was freed to find its own level, finally being stabilized early in 1933 at 3.60 pesos to the dollar, at which level it remained until March, 1938. The silver peso became the reserve behind Bank of Mexico notes. Direct lending activities of the Bank of Mexico were prohibited by this law, the prohibition being confirmed by a fundamental reform of the Bank of Mexico law on April 12, 1932. Coinage and issuance of Bank of Mexico notes were restricted for a transitional period after the July law, but were resumed by March 9, 1932, after a period of great monetary stringency.

The reform of the Bank of Mexico law in April, 1932, made the bank conform more to the pattern of activities of a central bank, not only by prohibiting direct lending to the public, but by requiring that all institutions covered by the General Law of Credit Institutions which received deposits of under thirty days, associate with it. This involved maintenance of non-interest bearing deposits at the Bank of Mexico by the commercial banks equivalent to five percent of their sight deposits, thus creating a centralized reserve under the control of the central bank. For several years afterward, supplementary legislation was passed elaborating upon the powers of the Bank of Mexico in relation to the associated banks, the monetary system, and the foreign exchanges.

The year 1932 proved to be the turning point in the business cycle. After this year, Mexico faced her first real opportunity since the revolution to develop her economy under auspicious conditions. Not until 1929 had real political stability been established, and then the general economic depression had interfered to retard normal recovery. One of the major elements responsible for the rapid Mexican recovery after 1932 was the rise in silver prices following the London Silver Agreement and the adoption of the silver purchase policy in the United States. The rising price finally brought the bullion value of the silver peso above its nominal value during April, 1935. To prevent any serious outflow of silver and consequent deflationary effects upon the Mexican economy,

a series of monetary reforms was passed on April 27, 1935, the most important effect of which was to demonetize silver and substitute paper currency. The measure was a success. It testified to the confidence of the public in the ability of the Bank of Mexico to redeem its currency for foreign exchange at the 3.60 rate, and reflected favorably upon the state of political and economic development of Mexico, which had heretofore been primarily a hard currency country.

Once the critical situation was past, the government undertook more permanent and significant reforms in the monetary system and central banking organization. On August 31, 1936, the new reforms officially placed Mexico on a managed currency basis, completely divorcing the peso from gold. The currency was to be managed by the Bank of Mexico, and Bank of Mexico notes as well as other sight obligations of the Bank of Mexico were to be backed at least twenty-five percent by a Metallic Reserve of gold, silver, and foreign exchange. The National Banking Commission was placed essentially under the control of the Bank of Mexico, thereby centralizing control over the commercial banking system. The Board of Directors of the Bank of Mexico was also given power to vary reserve requirements of the associated banks between three and fifteen percent plus fifty percent of the average daily payments by the banks on deposits. The Bank of Mexico was now to serve as a clearing house for the associated banks. Additional controls over the purchase of gold and foreign exchange were provided, and new limitations upon loans to the federal government were imposed.

The merchandise balance of trade improved rapidly after 1932, until 1935, but declined again in 1936 as the government program of agricultural and industrial development took hold and resulted in increased imports, both directly and through increases in general purchasing power. The attitude of the government was, however, hostile toward foreign enterprise, and very partial to organized labor. This was a deterrent to the influx of foreign capital, and even resulted in some outflow, as indicated by the records of a new capital export tax which

had been passed in 1934. Nevertheless, monetary reserves of the Bank of Mexico continued to rise during this period, except for the effects of a sporadic capital flight at the end of 1936.

Two major disturbances affected Mexico during the 1937-1938 period, both having repercussions on the balance of payments, and upon the domestic money, credit and price structure. One was the recession in the United States in the fall of 1937. The other was a major domestic crisis caused by the expropriation policy of the Mexican government culminating in the expropriation of the foreign-owned oil properties within the country. Although estimates of the net national product indicate a continued rise in these years, real net product as determined by deflating the foregoing estimates by cost of living or wholesale price indices, definitely declined in 1937 and may have declined in 1938, depending upon the index used. Production indices and unemployment statistics also reveal a recession in 1938.

The immediate effects of the recession in the United States and the domestic expropriation crisis were felt in the balance of payments through a decline in 1937 in the export balance of trade and a capital flight. The threat to the country's reserves resulted in the Bank of Mexico dropping its support of the peso in March, 1938, and brought increased import restrictions early in 1938. Although there was some contraction of credit and currency during the latter part of 1937 and early 1938, it is probable that the government's program of deficit financing prevented an even worse situation. The government financed its program largely through illegal overdrafts on its account at the Bank of Mexico, as well as through the sale of road bonds to the banks.

As a consequence of the developments during 1937 and 1938, especially the decline in the Metallic Reserve, the peso depreciation, and the greatly enlarged government debt to the Bank of Mexico, measures were taken during December, 1938 to modify the Bank of Mexico law. The main features were a revaluation of the Metallic Reserve, the increment being used

to cancel part of the government debt to the Bank of Mexico, changes in the lending powers of the bank in relation to the government and associated banks, the granting of permission to the bank to issue cash bonds as an anti-inflationary weapon, and a change in the status of part of the note issue.

The years 1939 and 1940 were essentially transitional years from the crises of 1937-1938 to the development of a war-oriented economy in 1941. Although merchandise export trade balances declined in the face of a rising value of total trade, the reserve position of the country improved as capital outflow declined and some refugee capital began to flow into Mexico from abroad, along with the repatriation of some Mexican capital. The uncertainties of these two years are best reflected in the changes in the exchange rate, monetary reserves, funds in circulation, and prices. The overall improvement in conditions is evident in the rising value of net national product during both 1939 and 1940. During these years trade began to shift to the United States, and the peso was stabilized at 4.86 pesos to the dollar, approximately the rate at which it remained until July, 1948.

The war brought about a reversal in Mexico's international economic position. For the five years, 1941 through 1945, the net merchandise import balance amounted to 568 million pesos. Nevertheless, due to increased tourist expenditures, workers' remittances from abroad, and capital imports, the gold and foreign exchange reserves increased to record heights. Reconciliation was achieved during this period with most of Mexico's foreign creditors on the basis of greatly scaled-down claims.

The favorable balance of payments situation, accompanied by an expanding government and private program of investment gave rise to a more than three-fold increase in the money supply. Faced with wartime supply restrictions in the belligerent countries and shipping shortages, and a relatively inelastic supply situation at home, the outcome was a rapid increase in price levels. To combat inflation, trade controls were imposed upon the economy, and the Bank of Mexico was

given additional monetary and credit control powers making it one of the most powerful central banks in Latin America. Legislation of May, 1941 and January, 1942 gave the Bank of Mexico power to raise reserve requirements for associated banks as high as fifty percent. There were also voluntary agreements entered into with commercial banks to limit the size and direction of their investments. The Bank of Mexico was helpless to carry out open-market operations and its rediscount powers were ineffective. Only limited success was achieved in curbing inflationary tendencies, prices approximately doubling between 1941 and 1945.

The termination of the war found Mexico with a pent-up demand for foreign goods which revealed itself almost immediately in a rapid expansion of imports over the wartime levels. By 1947 the decline in monetary reserves became sufficiently serious to impose added restrictions on imports. Despite the decline in reserves, money and credit were maintained at very high levels and prices continued to increase as the Bank of Mexico relaxed its credit controls and the government pushed an intensive program of public works and industrial development projects. Mexico's desperate balance of payments situation was only eased temporarily by loans from the United States, and by full utilization of the country's rights with the International Monetary Fund to buy 22.5 million dollars. Finally, on July 22, 1948, following a flight of dollars out of Mexico — which had occurred in anticipation of just such an action — the Bank of Mexico released its support of the peso, which quickly fell to about seven to the dollar.

It is very questionable whether depreciation, unaccompanied by other measures, can be an adequate solution to Mexico's problems. In view of the already existing pressure upon the productive resources of the country, depreciation will, in all likelihood, impose further inflation upon the economy with doubtful effect in remedying the balance of payments situation. Mexico faces the immediate alternatives of reducing domestic expenditures on public works and developmental programs, of continuing them but imposing direct and indirect restrictions

upon private consumption and investment expenditures, or of seeking out foreign loans to cover the chronic balance of payments deficit which would otherwise occur, or attempting a combination of all three. At least in the immediate future it is improbable that sufficient foreign aid can be relied upon.

From a long-range point of view, the program of industrialization in Mexico, in common with the rest of Latin America and other relatively less industrially mature economies, may be justified on three major grounds: 1) that it will bring higher living standards to the population; 2) that it will result in an expansion of world trade, as incomes and living standards rise; and 3) that it will result in greater economic stability domestically, and aid in promoting international economic stability. It is to be hoped that the development will occur along healthful lines of increasing productivity in an absolute sense, and that it will be adapted to achieve the optimum international division of labor. Whether this will occur will depend to a very great extent upon the successful achievement of international economic as well as political cooperation, and especially upon acceptance by the United States and other major industrial nations of their responsibility to the rest of the world to maintain domestic economic stability. These countries must also show a willingness to adapt themselves to programs of development in the so-called "backward areas" of the world, without taking measures to hinder the developments in order to protect selfish interests at home. If such cooperation is not achieved, we may well expect efforts to achieve economic autarky, and a regime of international economic anarchy.

It is likely that industrialization will proceed with or without the help of foreign investment. The more mature, more economically developed nations can help by providing aid during the transition period. Otherwise, industrialization may have to be achieved through a much longer, more arduous process, out of the relatively meager savings of the backward populations, and may result in greater regimentation and social and political frictions, and possibly even in sacrifice of

part of the present low living standards.

VITA

Nathaniel Jackendoff was born in New York City on February 24, 1919. He received all his elementary, high school, and under-graduate education in New York City, obtaining the degree of Bachelor of Science in Social Science from the City College of New York in 1938. All of his graduate study in economics was done at the University of Illinois, whence he obtained an A.M. in Economics in 1939, and where he is at present a candidate for the degree of Doctor of Philosophy in Economics. During the years 1941 to 1943, and for a short period during 1946, he was connected with the United States Army Air Force in a civilian capacity as instructor in aircraft electrical systems. Between December, 1943 and December, 1945, he served with the Air Force in a military capacity as aerial engineer-gunner. In the fall of 1945, he attended the Sorbonne, University of Paris, under the auspices of the United States Armed Forces Institute, to study French language and civilization. Since September, 1946, he has been with the University of Illinois as a teaching assistant in the Economics Department, except for the spring of 1948, when he held a fellowship from the Graduate College. He is married and has two sons.

